Is Europe addressing the wrong growth crisis?

Fabian Zuleeg

With new French President François Hollande's victory, some form of ‘growth pact’ to accompany the fiscal treaty has become a near certainty. This is a good thing: austerity without growth is not working; it neither leads to fiscal consolidation, nor does it encourage adequate structural reforms. And the social and political impact of this recipe will inevitably lead to meltdown, to which Greece is already precariously close. This is where the growth pact should be focused: on the countries in crisis and not on those countries, like France, which still have options left to reform themselves.

Achieving growth in the current situation is challenging. Europe is facing two growth crises at the same time: a sluggish overall growth level, in part predating the crisis, and growth divergence, with the countries in trouble on a downward spiral, opening an increasing gap with the best-performing countries. In both growth crises, achieving growth is not easy, especially when the public sector has only limited means available: huge amounts of public cash are unlikely to be pumped into Europe's economies, given the dire situation of public finances across the EU.

Structural reform is indispensable, but will – even under the best circumstances – take time to work. But Europe does not have this time. It is also doubtful whether merely cutting wages will work: despite free-falling real incomes, crisis countries such as Greece and Portugal are not regaining competitiveness, not least due to their lack of industry or services to exploit any improvement. Public spending cuts are hurting many policies which are important for future growth, whether in education or innovation. Mass unemployment is deteriorating human capital, raising the risk of a ‘lost generation’, as well as adding to the burden on public purses. The crisis is also discouraging investment in light of considerable uncertainty and by reducing the availability of capital and lending.

So, what can be done? Encouraging growth in the EU as a whole remains a priority, not least because it will enable further support for the crisis countries. Fixing Europe's banking system, completing the Single Market – including the Digital Single Market – deepening the transatlantic economic space, maintaining European Investment Bank (EIB) lending at the levels reached during the crisis, developing and deploying new financial instruments such as the Connecting Europe Facility and the use of 'EU project bonds', and continued loose monetary policy – accepting a modest increase in inflation – are all necessary for Europe as a whole. A re-evaluation of how public investments are treated in Europe's public finance governance should also be on the cards.

All this might help to address some of President Hollande's concerns. But he needs to be aware that structural reform and public finance consolidation are also still required – especially in countries like France, where reforms are needed for future growth, similar to the approach which Mario Monti is implementing in Italy. And these measures will not address the growth divergence crisis: the measures take time and do not specifically benefit the countries deepest in crisis.

The crisis countries need a more focused growth pact. The EPC has previously called for a 'New Deal' for the crisis countries, to provide investment for future growth. This logic still applies. The focus should be on identifying the negative consequences of the crisis on growth – through uncertainty, limited credit, high unemployment, etc. – and to address these as far as possible. This will not completely reverse the current situation – there is no magic formula – but it should mitigate some of the impact, provide a foundation for future growth, and provide hope and solidarity for citizens in the countries most affected by the crisis. In turn, this would help to address political and social challenges.

As immediate steps, the EU could use the unspent structural funds for the crisis countries, but these need to be spent differently to have a real effect:

- Finance basic public services – when education and health systems break down and when the state can no longer support people who need help, very little can be done to encourage growth;
• enhance credit availability for viable companies in the crisis countries, especially SMEs, which can be channelled through commercial banks via the EIB (building on the recently-announced SME guarantee fund);

• support people who have to move, for example through language training and relocation advice. Given falling labour demand in these countries, for many people it will only be possible to maintain their skill levels abroad;

• finance public service digitalisation projects, turning the crisis into an opportunity to drive public administration efficiency;

• provide SMEs in the crisis countries with support to put their business on the web and expand beyond the country’s borders;

• support creativity and innovation in companies and the education system, by matching each euro spent on R&D and by investing in e-literacy;

• develop and target new financial instruments which can combine public and private investment, for example EU infrastructure bonds, and;

• support infrastructure projects in the crisis countries. While these are unlikely to have a major impact on long-term growth, they could absorb in the short term some of the overcapacity in construction and thus alleviate mass unemployment.

These considerations should also shape negotiations over the EU’s next Multi-Annual Financial Framework. While this will only start to kick in after 2014, the impacts of the crisis are unlikely to have been overcome by then.

Critically, public money alone will not be enough: private investment is needed, not only from within the country but also from abroad. This will require a more radical approach: an insurance and guarantee scheme, which provides security against the additional risk which arises from the possibility of exiting the euro and economic melt-down.

The economically stronger countries should also help to reduce imbalances within the euro zone by encouraging domestic consumption and imports, as well as extending support schemes, for example for renewable energy, to the crisis countries. Providing for lower debt financing costs by partially collateralising debt and establishing a temporary transfer mechanism would also help, but admittedly these remedies are unlikely to feature in a comprehensive growth initiative, given the resistance to these measures in economically-stronger countries.

The growth pact is going to come and it can help to address Europe’s growth challenges if it contains some real measures focused on the crisis countries. This is essential to stop the current downward spiral and to provide social and political relief, ultimately safeguarding the euro. Europe’s leaders have to be brave enough to seize this opportunity – they will not get many more chances.

*Fabian Zuleeg is Chief Economist at the European Policy Centre (EPC) in Brussels.*